FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. WILLIAM J. MURPHY (CRD No. 1437087), CARL M. BIRKELBACH (CRD No. 1177843), and [redacted] Respondents.	Disciplinary Proceeding No. 2005003610701 Hearing Officer – LBB **EXTENDED HEARING PANEL DECISION** **May 6, 2010**

For exercising discretion in two clients' accounts without written authority from the clients or approval from his firm, engaging in unauthorized trading, recommending and effecting unsuitable transactions, and churning, Respondent William J. Murphy is barred from associating with any member firm in any capacity. Murphy is also fined $591,933.67 as disgorgement of commissions. In light of the bar, no additional sanction is imposed for creating and delivering misleading communications to a client. For entering into a settlement agreement with an improper confidentiality provision, Respondent [redacted] is fined $2,500. For failing to supervise, Respondent Carl M. Birkelbach is fined $25,000, suspended for six months as a general securities principal and options principal, and required to re-qualify before serving in either of those principal capacities.

Appearances

Marcletta Kerr, Esq., Principal Regional Counsel, and Dale A. Glanzman, Senior Regional Counsel, Chicago, Illinois, for the Department of Enforcement.

James J. Moylan, Esq., Steamboat Springs, Colorado, for Respondent.

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DECISION

The Department of Enforcement ("Enforcement") filed the Complaint in this disciplinary proceeding on August 1, 2008, asserting five causes of action against Respondent William J. Murphy ("Murphy"), one cause of action against Respondent Carl M. Birkelbach ("Birkelbach"), and three causes of action against Respondent [redacted] or the "Firm").[1] Murphy was charged with exercising discretion in the accounts of A.L. and B.M., two of his customers, without obtaining written authorization from the clients; effecting excessive and unsuitable trades in the accounts of A.L. and B.M.; churning the accounts of A.L. and B.M.; trading beyond the approved limits in A.L.'s account; and creating and distributing inaccurate, unbalanced, and misleading customer communications to customer A.L.

The Complaint charged Birkelbach with inadequate supervision of Murphy. The Firm was charged with failure to establish and maintain an adequate supervisory system and written supervisory procedures, failure to maintain written correspondence, and entering into a settlement agreement that contained an improper confidentiality provision.

A four-day hearing was held in Chicago, Illinois, from July 27 – 30, 2009, before an Extended Hearing Panel consisting of one current and one former member of the District 8 Committee and a Hearing Officer.

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[1] As of July 30, 2007, NASD consolidated with the member regulation and enforcement functions of NYSE Regulation and began operating under a new corporate name, the Financial Industry Regulatory Authority (FINRA). References in this decision to FINRA include, where appropriate, NASD. Following consolidation, FINRA began developing a new FINRA Consolidated Rulebook. The first phase of the new consolidated rules became effective on December 15, 2008, including certain conduct rules and procedural rules. *See* Regulatory Notice 08-57 (Oct. 2008). This decision refers to and relies on the NASD Conduct Rules that were in effect at the time of Respondent's alleged misconduct. In addition, because the Complaint was filed before December 15, 2008, the NASD Procedural Rules were applied in this disciplinary proceeding.

I. Respondents

[redacted] became a FINRA member on July 22, 1983, and is currently registered with FINRA. Stip. 1. The Firm employs about 21 people. Tr. 1094.

Birkelbach became registered with FINRA through [redacted] on July 22, 1983, as a General Securities Representative, Municipal Securities Representative, Registered Options Principal, Financial and Operations Principal, and Municipal Securities Principal, and is currently registered through the Firm. Stip. 2. He was the Firm's Senior Registered Options Principal ("SROP") and Compliance Registered Options Principal ("CROP") from October 2001 through February 2006. Stip. 3; Tr. 1115.

Murphy has been registered through [redacted] since November 7, 1995, and is currently registered there as a General Securities Representative and a General Securities Principal. Stip. 6.

II. Motions to Strike Affirmative Defenses

In their answer to the Complaint, Respondents asserted five affirmative defenses. On March 19, 2009, Enforcement moved to strike the affirmative defenses as legally insufficient. Respondent opposed the motion on April 3, 2009, arguing both that the motion was premature, and that the affirmative defenses are routinely asserted. By order of May 8, 2009, the Hearing Officer deferred ruling on the motion.

In their first affirmative defense, Respondents argued that the Complaint failed to state a claim upon which relief can be granted. This is not an affirmative defense. No ruling is required on the motion to strike this defense because the disposition of the nine causes of action necessarily includes a ruling on whether the Complaint states a claim upon which relief can be granted with respect to each cause of action.

In their second affirmative defense, Respondents asserted that all allegations in the Complaint are barred by the doctrines of *ratification*, waiver, and estoppel. Although Respondents have not explained the basis for the defense, Enforcement's motion to strike assumes that the basis is FINRA's failure to file the Complaint earlier. FINRA's failure to act sooner does not provide a basis for this affirmative defense.[2] This defense is legally insufficient, and is stricken.

In their third affirmative defense, Respondents argued that certain allegations in the Complaint, and the entire Ninth Cause of Action (relating to the confidentiality provision in the settlement agreement) should be stricken as irrelevant, immaterial, unduly prejudicial, and moot. Respondents have not shown that there is anything in the Complaint that is irrelevant, immaterial, unduly prejudicial, or moot. As discussed below, the use of a confidentiality provision in a settlement agreement may be a basis for a finding of a violation of FINRA's rules. The motion to strike is granted.

The fourth affirmative defense alleged that the entire Complaint is barred by the statute of limitations contained in 28 U.S.C. § 2462. As the Hearing Officer held in the Order Denying Respondents' Motion to Dismiss, dated December 9, 2009, "It has been held repeatedly that there is no statute of limitations for actions by self-regulatory organizations." The motion to strike is granted.

The fifth affirmative defense alleged that the allegations with respect to customer B.M. had already been settled with the Illinois Securities Department and with B.M. individually, and thus are moot. As set forth in the Order Denying Respondents' Motion to Strike, dated

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[2] *See Ronald Pellegrino*, Exchange Act Rel. No. 59125, 2008 SEC LEXIS 2843, at *54 – *55 (Dec. 19, 2008) ("'A regulatory authority's failure to take early action neither operates as an estoppel against later action nor cures a violation.'"), quoting *Stephen J. Horning*, Exchange Act Rel. No. 56886, 2007 SEC LEXIS 2796, at *34 (Dec. 3, 2007), *aff'd*, 570 F.3d 337 (D.C. Cir. 2009).

December 9, 2009, neither the settlement with the Illinois authorities nor the settlement with Respondents' customer affects FINRA's ability to bring a disciplinary action. The motion to strike is granted.

III. Origin of the Investigation

The investigation that led to the Complaint began in late November 2005, when FINRA's Member Regulation staff noticed the trading in customer A.L.'s account during a routine examination of [redacted] Member Regulation staff asked FINRA principal investigator Julie Murphy to review the account. Upon review, Ms. Murphy noticed that there was a high volume of trading in the account, there were uncovered options positions, and the customer was a single mother who lacked investment experience. Tr. 429 – 431.

IV. Facts

A. Relevant Options Transactions

Much of the Complaint arises out of Respondent Murphy's options trading in the account of customer A.L. The types of options Murphy traded in A.L.'s account are discussed below.[3]

1. Covered Calls

In executing a covered call, an investor who holds a stock sells, or writes, call options against the stock position. The seller of the call is obligated to sell the stock to the purchaser of the call during a set period of time at a set price ("strike price" or "exercise price"). The payment to the seller of the call is called the "premium." Covered call writing is a strategy that

[3] J. Marc Allaire, Enforcement's expert witness, discussed the relevant options strategies in his expert report. *See* . CX-37 at 3 – 5. This discussion is based on Allaire's report and the discussion of these strategies in a number of decisions and references. *See, e.g., Dep't of Enforcement v. Medeck*, No. E9B2003033701, 2009 FINRA Discip. LEXIS 7, at *1 n.1 (N.A.C. July 30, 2009) (hereinafter cited as "*Medeck*"); *Dep't of Enforcement v. Medeck*, No. E9B2003033701, 2006 NASD Discip. LEXIS 49, at *6, n.18 (O.H.O. Dec. 12, 2006); *Thomas J. Furnari*, Exchange Act Rel. No. 21046, 1984 SEC LEXIS 1358, at *2, n.2 (June 14, 1984) ; and Options Clearing Corporation, Understanding Stock Options, 1994 (available from the CBOE Education Center at https://cboe.com/LearnCenter/pdf/understanding.pdf).

reduces the risk of holding a long position in a stock, because the call writer retains the income from the sale of the call regardless of the price of the underlying stock.

2. Uncovered or "Naked" Calls

In an uncovered call, often called a "naked call," the writer sells the call without owning the underlying stock. The writer has the obligation to deliver the stock at a set price during a set period. If the price of the stock rises to a price above the strike price, the investor will have to cover either by buying the stock for delivery to the purchaser of the call, or repurchasing the call. Selling uncovered calls is considered a high-risk strategy because there is no limit to how much the price of a stock can increase, and therefore no limit to the seller's exposure.

3. Long Calls

Some of the transactions involved in the case were purchases of calls, or "long calls." The purchaser of a call is the counterparty to the writer of a call, and has the right to buy the stock from the writer at a set price during a set period of time. If a purchaser already owns a stock, the purchase of a call option will magnify the gains and losses on the stock. If the stock goes above the strike price, the purchaser profits from the stock itself, and from the increased value of the call. If the stock goes down, the purchaser of a call who owns shares in the underlying stock loses on the stock itself, and the call becomes worthless when it expires.

4. Put Options ("Short Puts")

The seller, or writer, of a put option has the obligation to purchase shares of the underlying stock at a set price during a set period of time, and receives a premium for taking on this obligation. If an investor owns a stock, the selling of put options increases the risk. If the price of the underlying stock falls below the strike price, the seller will be obligated to purchase the stock at the strike price, losing money on the put, and also losing money on his holdings in the underlying stock.

B. The A.L. Account

A.L. was an inexperienced investor who had received a substantial amount of stock from her father. She invested part of the stock with [redacted] intending to use the investment strategy of writing (selling) covered calls. When Murphy took over her account, he made a large number of options trades, traded frequently, and engaged in several other types of options transactions in addition to covered calls. The result was very large commissions for Murphy and the Firm, and substantial losses for A.L.

1. Opening of the Account at [redacted]

In the fall of 2001, A.L. was a recently divorced mother of three children. She earned a small amount of money as a writer and illustrator of children's books and as an artist. Tr. 105 – 106, 118. She received no child support from her former husband. Tr. 105 – 106; JX-15. A.L.'s father had been a very successful businessman. He had risen to a high level at Procter & Gamble ("P&G"), and had accumulated a substantial amount of P&G stock. In 1998, A.L.'s father donated 47,000 shares of P&G stock, worth about $4 million, to a trust for the benefit of A.L. Tr. 108 – 109, 183. A.L.'s annual income of about $55,000 was largely derived from dividends from the P&G stock she had received from her father. Tr. 117 – 118.

In 2001, a friend who was a trader recommended a covered call strategy to A.L. Her friend recommended that she invest with Pat Jage, a registered representative at [redacted] Tr. 110, 208 – 209. Other than owning the P&G stock, A.L. had little investment experience. Tr. 109. Her only experience with options trading was that she had sold one covered call in 2001 with help of the friend who was a trader, so she could learn how covered calls were done. Tr. 112, 202 – 203; RX-32. She had no experience in trading uncovered options. Stip. 28. She did not understand what a put was. Tr. 332. She incorrectly believed that selling puts was part of a covered call strategy. Tr. 128.

A.L. opened an account for her trust at [redacted] on October 5, 2001. The new account form showed that A.L. had an income of "$55,000 plus," a liquid net worth excluding her home of $2,500,000, and a risk exposure of "moderate." The form also showed that A.L. was single, 44 years old, with three dependents, and had been self-employed as an artist for 25 years. The form listed her investment objectives as income and long-term growth. The form also showed that she had not granted written discretionary authority over her account to anyone. Stip. 11; JX-15. Her account was not approved in writing by the Firm for discretionary trading. Stip. 17.

A.L. also completed an Options Agreement and Approval Form on October 5, 2001. The Options Agreement showed that A.L. had an income of "$55,000 plus." It listed her investment objectives as "income" and "income & appreciation." The form showed that A.L. had one year of options investment experience. The boxes authorizing covered writing and buying of stock options were checked on the form. Stip. 12; JX-16. Birkelbach signed the Options Agreement in October 2001, and thereby approved the account for covered call writing and buying of stock options. Stip. 16.

A.L. funded the account with 20,000 shares of P&G stock, valued at approximately $1,500,000. Stip. 13; Tr. 114, RX-4. Until A.L. opened her account at the Firm, all of her P&G stock had been at Fidelity Investments ("Fidelity"). She kept 20,000 shares at Fidelity when she opened her account at the Firm. Tr. 109, 114. A.L. wanted to generate cash income in the account she opened with [redacted] but she did not want to sell her shares of P&G stock. Stip. 14; Tr. 321, 1140. Throughout the time that Respondent was a client of the Firm, it was important to A.L. not to sell P&G stock. Tr. 111 – 112. A.L. did not want the P&G stock to be sold, or called away, because her father had told her that she should not sell the stock, she had

an emotional attachment to the stock, and she had a very low tax basis in the stock. Her father had started buying P&G stock as an employee in 1941, and her basis was about $12 per share. Tr. 111 – 112, 189 – 190. At the time the 20,000 shares were deposited with the Firm, P&G was trading at about $75 per share. JX-18.

She understood that the Firm would engage in a covered call strategy that would generate income and not let the P&G stock get called away. Tr. 122.

2. Transfer of the Account to Murphy and Murphy's Management of the Account

In July 2002, Jage became ill and Murphy took over A.L.'s account. Murphy was the registered representative on the account from July 2002 through February 2006. Tr. 122, 995; Stip. 18. When Murphy took over the account, A.L. was upset because she had lost money while Jage was managing her account.[4] Murphy assured her that it would not happen again. He said he would reduce the commission charges, and she would make money. Tr. 206 – 207. A.L. told Murphy that she wanted income, but did not want any stock to get called away. Tr. 128 – 129, 1041 – 1042; Stip. 20. Murphy told A.L. that he would effect a covered call strategy in her account. Stip. 19. Despite receiving recommendations to diversify from her financial adviser, Murphy, and others, A.L. did not think she needed to diversify because her father had told her that P&G was already diversified. Tr. 112, 139, 230 – 232, 341, 723 – 724, 1043.

Soon after Murphy took over the account, the level of trading, and the level of commissions, increased dramatically, and accelerated over time. CX-1. A.L. gave Murphy verbal permission to exercise discretion in her account, but she never gave him written permission. Murphy spoke to A.L. about once a month at the beginning of the time he handled her account, but about once a week toward the end. He did not talk to A.L. before every trade.

[4] A.L. testified that her losses under Jage were $41,000. Tr. 206. In fact, her losses under Jage's management of her account were $10,650.81. CX-5 at 3.

He traded when he thought it was appropriate. Tr. 140 – 141, 318, 1014; JX-176 at 194. Murphy recommended all trades in A.L.'s account, and made all trading decisions, from July 2002 through February 2006. Stip. 21.

Murphy wrote to A.L. on July 2, 2004, reassuring her that the account was doing well with a covered call strategy. He stated, "[T]he strategy that we have always tried to adhere to involved selling covered calls on the Procter & Gamble stock, generating premium income from same for personal use, with the overriding caveat that under no circumstances should we allow the stock to be called away as a result of a price increase." A.L. understood the letter to confirm that Murphy was following a covered call strategy in her account. Tr. 149 – 150, JX-192 .[5] However, at the time of the letter, in addition to writing covered calls, Murphy had written uncovered calls, purchased calls ("long calls"), sold puts ("short puts"), and engaged in short combinations.[6] CX-7; CX-12; Stip. 26. In fact, on the day the letter was sent, A.L.'s account held both long calls and short puts. CX-3 at 185; CX-7 at 84.

Murphy's letter described the strategy for A.L.'s account as designed "to generate safe income to offset increased living expenses." The letter said that when he took over the account, it had a loss of $65,000, and that he was "working off of that loss."[7] Murphy told A.L., "The losses and gains that have occurred since 2001 came as a result of P&G stock rising in value." A.L. understood from the letter that she was making money because it said that the funds that had been paid to A.L. out of the account "represent dividends paid, profits from options trading

[5] Although CX-192 contains many material misrepresentations, the Complaint does not charge Murphy with making misrepresentations in the letter. Nevertheless, the misrepresentations may be considered in determining the appropriate sanctions. Principal Consideration #10, *FINRA Sanction Guidelines* at 6 (2007) (whether Respondent intended to conceal his misconduct or mislead his customer).

[6] The "short combinations" were short calls and short puts of P&G stock with the same expiration date but a different strike price. Tr. 450; CX-7. For example, on October 11, 2002, the account was short 100 January 2003 puts at a strike price of $85, and 100 January 2003 calls at $95. Tr. 450 – 451; CX-7 at 9.

[7] As noted earlier, the actual loss was $10,650.81. CX-5 at 3.

and income from covered call options." JX-192; Tr. 155. In fact, she had lost $275,782.75 in options transactions since Murphy took over the account. CX-15.

On November 1, 2004, A.L. was instructed to, and did, sign her original Options Agreement and Approval Form a second time. Stip. 22; JX-17; Tr. 129-130, 411 – 412. Someone from [redacted] told A.L. that the purpose of signing the same form a second time was to change her name on the account, due to her divorce.[8] Tr. 130 – 131, 227, 411 – 412. In fact, there was a material change in the form, adding check marks in the boxes for "spreading" and "uncovered writing." JX-16; JX-17. Murphy and Birkelbach did not tell her that there was a change in the product approvals. Tr. 132. Birkelbach approved the form, thereby approving A.L.'s account for uncovered options trading. Stip. 32; CX-17. Respondents wanted her to sign a new form because a FINRA examiner had discovered uncovered calls during a routine examination. Murphy testified that the examiner had discovered 17 uncovered calls, which he said were the result of his mistake in failing to consider that $800,000 of P&G stock secured a loan from Pershing. Shares that had been pledged could not be used to cover the calls. Tr. 694 – 695, 1029, 1079 – 1081. However, the pledging of the P&G stock as security for the margin account does not explain all the uncovered calls. There were many days on which the number of calls exceeded 200, and thus the number of callable shares exceeded the 20,000 shares in A.L.'s account. Even if there had been no margin debit, many calls would have been uncovered. CX-7; CX-12; CX-14.[9] Furthermore, Murphy continued to write uncovered calls

[8] A.L. did not identify who asked her to sign the document.

[9] For example, on November 15, 2002, there were 200 covered calls in A.L.'s account, and 40 uncovered, or "short," calls. CX-7 at 13. The combined 240 calls would have required 24,000 P&G shares in the account for all to be covered. See also, e.g., July 2, 2003 (275 total calls); July 31, 2003 (329 total calls); August 4, 2003 (579 total calls).

after November 1, 2004, although in smaller quantities and less frequently. CX-7. The evidence contradicts Murphy's assertion that he wrote uncovered calls inadvertently.[10]

While her account was at [redacted] A.L. always thought Murphy was following a covered call strategy. Tr. 132. She was never told that Murphy was engaging in uncovered calls or uncovered puts. Tr. 407 – 408.

As the losses in A.L.'s account mounted, the debit balance in her margin account grew. CX-14 at 2. She did not understand the account statements, and she did not look at everything she received from [redacted] Murphy regularly assured A.L. that her account was profitable, and she accepted his assurances until her accountant told her in the first quarter of 2005 that there were losses, and that the debit in her margin account was quite large. Tr. 123, 151 – 152, 262 – 263, 271. She called Murphy, who assured her that the debit balance was not a true indicator of margin because the money had gone to fund covered calls, and because she had funded a home equity loan from the margin account. A.L. did not understand his explanation. Tr. 152 – 153.

In about April 2005, A.L. instructed Respondent to be conservative and "stop the bleeding," to make some covered calls and collect the premiums, and to let the stock get called away to reduce the balance in the margin account. Tr. 156, 340 – 343; RX-63. In December 2005, A.L.'s accountant told her that, contrary to her instructions, Murphy was still trading heavily in her account. A.L. wrote to Murphy on January 17, 2006, directing that there be no more options trading. RX-50; Tr. 169 – 171. She transferred the P&G stock to Fidelity in March 2006, and closed the [redacted] account in April 2006. RX-8; RX-9; Tr. 362.

[10] The Hearing Panel did not find Murphy to be a credible witness. There were a number of contradictions such as this. He was at times combative and evasive in responding to questions. He also appeared to be confused in answering questions about his knowledge and experience with respect to options trading.

3. Murphy's High Level of Trading of Several Types of Options

Murphy traded more than 67,000 P&G options contracts in A.L.'s account from July 2002 through February 2006. Stip. 23. Murphy effected the following options strategies in A.L.'s account, at times simultaneously: short combination positions, covered writes, long calls, short calls, and short puts. Stip. 27.

Murphy purchased the first call for A.L.'s account on July 25, 2002, very soon after he took over the account. CX-7 at 4. Murphy made his first uncovered trade in A.L.'s account on August 27, 2002, just a few weeks later. CX-7 at 5. He wrote his first put on August 27, 2002. CX-7 at 5. From July 2002 until November 2004, the account was "short" at least one position, either short puts, uncovered calls, or short combinations, on 277 trading dates. At the end of every month that Murphy managed A.L.'s account, there were options positions in the account that were not covered calls. CX-12; Tr. 489. Murphy recommended and effected short-term trades of P&G options in A.L.'s account. Stip. 25. He engaged in substantial in-and-out trading. CX-10.

During the period Murphy handled A.L.'s account, A.L. paid $1,002,100.86 in commissions and $125,034.28 in margin interest. Stip. 24. Starting in October 2003, A.L. had a debit in her margin account until it was closed in early 2006. The margin balance reached more than $1 million dollars in 2005. CX-14. During the time Murphy managed A.L.'s account, she lost $871,301.95.[11]

C. The B.M. Account

B.M. was a college student in Chicago when he opened an account at [redacted] in May 1999. Tr. 65, 71. He has been an active member of the United States military

[11] This amount is calculated as follows: total losses on A.L.'s options trades were $881,952.76. Losses while Jage managed the account were $10,650.81. Total losses under Murphy were obtained by subtracting losses incurred by Jage from total losses in the account. CX-6 at 123; CX-5 at 3.

service since August 2001. Stip. 37; Tr. 47 – 49; JX-148.[12] George Langlois was the registered representative who handled the account when it was first opened. Tr. 66. B.M.'s new account form showed that he was a single person with one year of investment experience, an annual income of $15,000, and a liquid net worth of $2,300 as of May 1999. The new account form listed his investment objectives as long-term growth and short-term trading, and his risk exposure as speculation. This new account form was never amended, and was the only new account form maintained by the Firm for B.M.'s account. Stip. 38; JX-148.

In April 2007, B.M.'s account was transferred from Langlois to Murphy, when Langlois left [redacted] and joined a different brokerage firm. Tr. 50, 54, 57; Stip. 41. Murphy served as B.M.'s registered representative from the middle of April 2007 through the middle of June 2007. Stip. 42. B.M. did not give written or verbal discretionary authority to Murphy to trade without talking to B.M. Tr. 51 – 52; Stip. 39. B.M.'s account was not approved by the Firm for discretionary trading. Stip. 40.

Because he was stationed in Germany during the time he was Murphy's client, it took about a month to receive confirmations and account statements. B.M. told Murphy about the delay. Tr. 52 – 54. Murphy never called B.M., but B.M. called Murphy three times between April and July 2007. Tr. 54. During the first call, in late April 2007, Murphy recommended that B.M. shift from the penny stocks that Langlois had bought for the account to more conservative stocks. B.M. told Murphy that he would think about it. Tr. 54 – 55, 75 – 76. B.M. called Murphy in late May or early June, after receiving an account statement showing a number of trades, high commissions, and substantial losses. B.M. had not authorized any transactions. B.M. said he did not want to do any more trades, and the commissions were too high. He said he

[12] Because B.M., a member of the U.S. military forces, is currently stationed in Germany, he testified by telephone. His candor and carefulness in responding to questions were apparent to the Hearing Panel even on the telephone, and the Hearing Panel found him to be a very credible witness.

was going to transfer his account to Langlois at Langlois's new firm. Tr. 55 – 56, 97 – 98. Murphy claimed that there had been a misunderstanding, and refunded some of the commissions. Murphy told B.M. that there was $13,000 left in the account, and that $3,000 in commissions would be refunded. Tr. 57, 95. B.M. again called Murphy after receiving an account statement showing that Murphy had continued to trade in the account, and that the account was worth less than $13,000. Tr. 92 – 93, 98 – 99.

During the three months that Murphy managed B.M.'s account, Murphy recommended and effected 26 trades of 14 stocks in B.M.'s account. Stip. 44. B.M. paid approximately $5,395.77 in commissions and sustained losses of approximately $5,703.59 from the trading Murphy effected in his account. Stip. 45. B.M. did not authorize any of the transactions that Murphy made in the account. Tr. 56 – 59; JX-158; JX-159; JX-160.

BM closed his account at [redacted] in early July 2007, and transferred it to Langlois. Tr. 64, 90; JX-161.

V. Causes of Action

A. First Cause of Action: Murphy Violated NASD Conduct Rules 2510(b), 2860(b)(18), and 2110 by Engaging in Discretionary Trading Without Written Authorization from His Clients or His Firm

NASD Conduct Rule 2510(b) provides, "No member or registered representative shall exercise any discretionary power in a customer's account unless such customer has given prior written authorization to a stated individual … and the account has been accepted by the member …." Similarly, NASD Conduct Rule 2860(b)(18)(A) prohibits a registered representative from exercising discretion in making options trades unless the written

authorization for discretionary trading required by Rule 2510 specifically authorizes options trading in the account and the account is accepted in writing by a Registered Options Principal.[13]

A.L. gave verbal, but not written, authorization to Murphy to make trades without consulting her. [redacted] did not accept the A.L. account as discretionary. Despite the lack of written authorization, Murphy regularly made options trades in A.L.'s account without consulting her. By trading in A.L.'s account without written authorization from A.L. or the Firm, Murphy violated NASD Conduct Rules 2510(b), 2860(b)(18)(A), and 2110.[14]

B.M. did not give either written or verbal authorization to Murphy to make trades in his account, nor did [redacted] accept B.M.'s account for discretionary trading.[15] Nonetheless, over a three-month period, Murphy made 26 trades in B.M.'s account without prior authorization from the client to make the trades. By trading in B.M.'s account without written authorization from B.M. or the Firm, Murphy violated NASD Conduct Rules 2510(b), 2860(b)(18)(A), and 2110.

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[13] FINRA's Options Rule is now FINRA Rule 2360. See Reg. Notice 08-78. As noted above, this matter has been decided under the NASD rules in effect at the time of the violations.

[14] "It is well established that a violation of a Commission or NASD rule or regulation is inconsistent with just and equitable principles of trade, and is therefore also a violation of Rule 2110." *Kirlin Securities*, Exchange Act Rel. No. 61135, 2009 SEC LEXIS 4168, at *59 – *60, n.81 (Dec. 10, 2009).

[15] Even if B.M. had agreed to the strategy of selling the penny stocks and moving to a more conservative strategy, it would not have constituted even verbal discretionary authority. *Dep't of Enforcement v. Sathianathan*, No. C9B030076, 2006 NASD Discip. LEXIS 3, at *38 – *39 (N.A.C. Feb. 21, 2006) (finding that trading in a customer's account without specific authorization from the customer based on general investment strategy discussions did not constitute price and time discretion, and was unauthorized discretionary trading in violation of NASD Conduct Rules 2510(b) and 2110).

B. Second Cause of Action: Murphy Violated NASD Conduct Rules 2310, 2860, 2110, and IM-2310-2 by Engaging in Excessive and Unsuitable Trading

In *Dep't of Enforcement v. Medeck*,[16] the National Adjudicatory Council ("NAC") recently addressed the standards to be applied in determining whether a broker has engaged in excessive and unsuitable trading. As the NAC stated in *Medeck*:

> There are three main suitability obligations. First, a broker must have a reasonable basis to believe, after performing adequate due diligence, that the recommendation could be suitable for *some* investors ("reasonable-basis suitability"). Second, a broker must have reasonable grounds to believe that the recommendation is suitable for the specific customer at issue ("customer-specific suitability"). Third, a broker must have reasonable grounds to believe that the number of recommended transactions within a particular period is not excessive ("quantitative suitability").[17]

The Complaint in this case charges that Murphy engaged in both the second and third types of unsuitable trading in A.L.'s account – failing to have reasonable grounds to believe that the trading was suitable for the specific customer, and engaging in an excessive number of transactions. For customer B.M., the Complaint charges only excessive trading of equities – quantitative unsuitability.

1. Excessive and Unsuitable Trading in A.L.'s Account

The Complaint charges that Murphy engaged in excessive and unsuitable trading in A.L.'s account, alleging that the trading strategies were unsuitable because: the number of trades was excessive; the trades were effected using an excessive amount of margin; the trading of uncovered options was speculative and exposed A.L. to substantial or unlimited risk of loss; the trading exacerbated the lack of diversification in A.L.'s account; and, overall, the trading strategies were unsuitable. According to the Complaint, the cost-to-equity ratios in A.L.'s account show that the trading was excessive in size and frequency in view of the customer's

[16] No. E9B2003033701, 2009 FINRA Discip. LEXIS 7 (N.A.C. July 30, 2009).

[17] *Medeck* at *31 (emphasis in original).

financial situation and investment objectives. The Hearing Panel finds that Murphy engaged in excessive and unsuitable trading in A.L.'s account as alleged in the Complaint.

a) Excessive Trading in A.L.'s Account

Quantitative suitability focuses on "whether the number of transactions within a given timeframe is suitable in light of the customer's financial circumstances and investment objectives. Put another way, certain recommended transactions, viewed individually, might be suitable for a customer under customer-specific and reasonable-basis analyses, but those same recommended transactions, taken together, may be excessive and quantitatively unsuitable for that same customer."[18] In determining whether trading is excessive, "factors such as the turnover ratio, the cost-to-equity ratio, the use of 'in and out' trading, and the number and frequency of trades in an account introduce some measure of objectivity or certainty into the analysis and provide a basis for a finding of excessive trading."[19] Here, all the factors support a finding that Murphy engaged in excessive trading.

The sheer number of trades was enormous. Murphy traded more than 67,000 options contracts in A.L.'s account from July 2002 through February 2006. Stip. 23. During much of the period, Murphy made trades in A.L.'s account on most trading days. For example, in 2004, Murphy traded P&G options in A.L.'s account on about 185 days, with multiple trades on most days. CX-4.

The cost-to-equity ratios for the account were high. The cost-to-equity ratio, or cost-to-equity maintenance factor, is a calculation of the percentage return on a customer's average net equity needed to pay the broker-dealer commissions and other expenses, such as margin interest.

[18] *Medeck* at *32; *see also Dep't of Enforcement v. Kelly*, No. E9A2004048801, 2008 FINRA Discip. LEXIS 48, at *20 – *21 (N.A.C. Dec. 16, 2008) (hereinafter cited as "*Kelly*").

[19] *Medeck* at *42. The turnover ratio is often used in the analysis of excessive trading in long equity positions. The cost-to-equity ratio is a more appropriate quantitative measure of excessive trading for options. *Medeck* at *45 – *46.

It is the percentage appreciation needed on an annual basis to break even. Tr. 464.[20] Excessive trading has been found in cases in which the cost-to-equity ratio was in excess of 20%.[21] The cost-to-equity ratio for the entire period during which Murphy managed A.L.'s account was sufficiently high to support a finding of excessive trading. For 2004 and 2005, the ratio substantially exceeded the levels that have been held to support findings of excessive trading. The ratios were as follows:

Cost-to-Equity Ratio For A.L.'s Account[22]

	July through December 2002	**2003**	**2004**	**2005**	**January and February 2006**	**Entire Period July 2002 through February 2006**
Cost-to-Equity Ratio (Annualized)	9.88%	19.31%	31.25%	48.56%	8.80%	25.59%
Cost-to-Equity Ratio minus margin interest (Annualized)	9.82%	19.12%	27.78%	39.32%	4.21%	22.75%

"The term 'in and out' trading refers to the sale of all or part of a portfolio, with the money from the sale being reinvested in other securities, followed by the sale of the newly acquired securities."[23] Murphy engaged in frequent in-and-out trading. FINRA's investigator

[20] *Medeck* at *13; *see also Rafael Pinchas*, Exchange Act Rel. No. 41816, 1999 SEC LEXIS 1754, at *18 (Sept. 1, 1999) (hereinafter cited as "*Pinchas*").

[21] *Medeck* at *43; *see also Harry Gliksman*, Exchange Act Rel. No. 42255, 1999 SEC LEXIS 2685, at *12 (Dec. 20, 1999) (18% annualized); *Peter C. Bucchieri*, Exchange Act Rel. No. 37218, 1996 SEC LEXIS 1331, at *11 (May 14, 1996) (finding that cost-to-equity ratios from 20% to 30% supported a finding of excessive trading); *Sandra K. Simpson*, Exchange Act Rel. No. 45923, 2002 SEC LEXIS 1278, at *49 (May 14, 2002) (under the facts of the case, for conservative investors of modest means, 11.98% percent to 54.95% was considered excessive).

[22] CX-13.

[23] *Medeck* at *37, n.20, citing *Costello v. Oppenheimer & Co.*, 711 F.2d 1361, 1369 n.9 (7th Cir. 1983).

identified 59 instances of in-and-out trading of P&G options. In 40 of the 59 instances, A.L.'s account lost money. CX-10; Tr. 468 – 469.[24] In fact, even when Murphy had an unusual run of successful trades, A.L. lost money overall because the commissions exceeded the gains on the trades. Tr. 1089 – 1091.

Another element of a charge of excessive trading is control over the account. Control can be established either by showing that that broker had discretionary authority or *de facto* control over an account. A broker is deemed to have *de facto* control when the client routinely follows the broker's advice "because the customer is unable to evaluate the broker's recommendations and to exercise independent judgment."[25]

Murphy clearly exercised control over A.L.'s account. Murphy managed the account as if he had discretionary authority, making trades without contacting A.L.[26] In addition, Murphy made many unauthorized trades, including uncovered calls, long calls, and puts. Unauthorized trading constitutes "clear evidence of control" for the purposes of an excessive trading claim.[27] Furthermore, A.L. was clearly unable to evaluate Murphy's handling of her account. She had no experience in active trading, and she did not fully understand options trading. For example, she did not understand what puts were. She testified that she understood that a put was part of a covered call strategy, but it is not. She also did not understand the account statements she

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[24] "In and out trading is 'a practice extremely difficult for a broker to justify' and can, by itself, provide a basis for finding excessive trading." *Pinchas* at *15, citing *Costello* at 1369 n.9.

[25] *Medeck* at *34.

[26] *See Kelly*, at *13 – *14 (exercise of discretion without proper written authority due to failure to obtain approval of firm constitutes control).

[27] *Dep't of Enforcement v. Haq*, No. ELI2004026701, 2009 FINRA Discip. LEXIS 3, at *22 – *23 (Apr. 6, 2009); *see also Pinchas* at *20 n. 22 (Sept. 1, 1999) ("Transactions that were not specifically authorized by a client but were executed on the client's behalf are considered to have been implicitly recommended within the meaning of [FINRA's] rules.") (citation omitted).

received from [redacted] and accepted Murphy's assurances that she was making money despite the losses that she was incurring.

For the foregoing reasons, the Hearing Panel finds that Murphy violated NASD Conduct Rules 2310, 2860, 2110, and IM-2310-2 by engaging in excessive and unsuitable trading.

b) Qualitatively Unsuitable Trading

Before recommending a trading strategy, a registered representative must determine whether the strategy is suitable for the specific customer.[28] "A registered representative is obligated to make 'a customer-specific determination of suitability and to tailor his recommendations to the customer's financial profile and investment objectives.' Even if a customer understands a broker's recommendation and decides to follow it, this does not relieve the broker of the obligation to make reasonable recommendations."[29]

Options are commonly considered risky, speculative investments.[30] Conduct Rule 2860(b)(19)(B) codifies a heightened suitability standard for options trading. A broker is prohibited from recommending any options transaction unless the broker has reasonable grounds to believe that the recommended transaction is consistent with the customer's investment objectives, financial situation, and needs. The broker must have a reasonable basis for believing that "the customer has such knowledge and experience in financial matters that he may

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[28] *Kelly* at *23.

[29] *Luis Miguel Cespedes*, Exchange Act Rel. No. 59404, 2009 SEC LEXIS 368, at *19 (Feb. 13, 2009); *see Jack H Stein*, Exchange Act Rel. No. 47335, 2003 SEC LEXIS 338, at *8 (Feb. 10, 2003) ("Even in cases in which a customer affirmatively seeks to engage in highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile."); *Dane S. Faber*, Exchange Act Rel. No. 49216, 2004 SEC LEXIS 277, at *24 (Feb. 10, 2004) ("A recommendation is not suitable merely because the customer acquiesces in the recommendation. Rather, the recommendation must be consistent with the customer's financial situation and needs."); *Dep't of Enforcement v. Guang Lu*, 2004 NASD Discip. LEXIS 8, at *27 – *28 (N.A.C. May 13, 2004).

[30] *See Patrick G. Keel*, Exchange Act Rel. No. 31716, 1993 SEC LEXIS 41, at *5 & n.7 (Jan. 11, 1993).

reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract."

Murphy wrote many uncovered calls in A.L.'s account. Because the writer of an uncovered call assumes an obligation to sell something she does not own, the risk to A.L. was theoretically unlimited since there is no limit to the amount by which the price of a stock can increase. Uncovered calls should be written only by experienced traders willing to assume a high degree of risk, and A.L. was neither. Tr. 614 – 615, 947 – 948, 966 – 967; CX-37 at 6.[31] The selling of the uncovered calls was unsuitable. The strategy was very risky, contrary to A.L.'s stated moderate risk tolerance, contrary to the agreed-upon covered call strategy, and inconsistent with her objectives of generating income and protecting her P&G stock. Because the volume of calls that Murphy wrote often exceeded the 20,000 shares in A.L.'s account, all of her available P&G stock was exposed to the risk of being called away, and she had the added unlimited risk of having to cover at whatever price P&G stock reached if its price exceeded the exercise price.

Murphy also sold puts from A.L.'s account, obligating her to purchase P&G stock at a stated price during a set period. Puts were not part of the covered call strategy that Murphy was supposed to implement, and again subjected A.L. to substantial risk. At the end of August 2003, the account was short 300 P&G puts, with an exercise price of $80. At the time, the value of her account was about $1.5 million, largely in P&G stock. The price of P&G stock was $87.29. If the price of P&G stock had fallen below $80, A.L. would have been obligated to purchase an additional 30,000 shares of P&G, for $2.4 million. The net result is that A.L. was even more exposed to a decline in the shares of P&G stock than she had been, contrary to Murphy's own

[31] *See Dep't of Enforcement v. Bendetsen*, No. C01020025, 2004 NASD Discip. LEXIS 13, at *13 (N.A.C. Aug. 9, 2004) (uncovered calls are inherently speculative).

advice to her to diversify. She was exposed to a risk of having to purchase P&G stock that would cost more than the value of her account. CX-37 at 7; JX-39; Tr. 619, 659 – 661. The sale of puts was unsuitable for A.L. in light of her objectives and financial position.

Murphy purchased large quantities of P&G calls in A.L.'s account. Purchasing calls is a speculative strategy. If the value of the stock declines, the calls expire worthless, and the purchaser loses 100% of her investment. For A.L., purchasing calls while maintaining her position in P&G stock increased her exposure to a decline in the value of P&G stock, making the purchase of calls even riskier. It was unsuitable and inconsistent with A.L.'s stated objective of generating cash. CX-37 at 6. An example of Murphy's unsuitable trading occurred early in December 2005. Murphy's trading resulted in a total long position in P&G options in A.L.'s account of 3,300 call options. The calls cost $304,500, while the value of the account was about $900,000 at the time. The calls were purchased on margin because there was no cash in the account. Enforcement's expert accurately described these transactions as "a massive bet that P&G would rally strongly in the short term," and "a very speculative gamble." Tr. 635 – 638; CX-37 at 11.

The high margin balance that Murphy used to make cash distributions to A.L. and to cover up the account's losses was also inconsistent with A.L.'s objectives.[32] The margin balance would have to be repaid eventually, and the only source of repayment was likely to be the P&G stock that A.L. did not want to sell.[33] Thus, while Murphy maintained the appearance of complying with his client's express directive to maintain the stock, he was merely postponing the inevitable sale of the stock while he continued to reap large commissions.

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[32] For a brief period, part of the margin balance was the result of a home equity loan to A.L. The Hearing Panel did not include that loan in its determination that Murphy engaged in unsuitable trading in A.L.'s account.

[33] Given the high margin balances, even an extraordinary run of good luck and extraordinary dividend payments from P&G were not likely to be enough to pay off the margin account.

Even if Murphy had actually followed A.L.'s instructions to pursue a covered call strategy, it was not a strategy that was designed to meet A.L.'s objectives of generating income and not selling her stock. The two objectives are contradictory. As Enforcement's expert witness put it, A.L. was asking "for [her] cake and [she's] asking to eat it too," i.e., for "mission impossible." Tr. 669 – 670, 687 – 688. In fact, when the price of the underlying stock rises sufficiently, a covered call strategy with a restriction on selling the stock is a cash drain. If the stock rises beyond the options' exercise price, either the stock must be sold or the calls repurchased. Tr. 606 – 607; CX-37 at 4, 6.

One result of Murphy's trading was that A.L. had a very complex portfolio of P&G options, often simultaneously owning multiple options types. Tr. 624 – 625. The complexity made it difficult even for Murphy to determine which scenarios would lead to gains and which would lead to losses in the portfolio, commissions aside. Tr. 1054 – 1055. Often the only clear winners were Respondents, who were receiving substantial commissions regardless of the outcome.

As noted above, A.L. re-signed her Options Agreement and Approval Form in November 2004, but was unaware that the firm had added checkmarks for the approval of uncovered options transactions. Murphy had already engaged in a substantial number of unsuitable transactions by November 2004, including the sale of a number of uncovered calls. Thus, if this document somehow made all subsequent trades suitable, there had already been more than enough unsuitable transactions to establish an extended pattern of serious violations. However, even for the period after November 2004, the document does not excuse Respondents' conduct. Respondents obtained A.L.'s signature on the document deceptively, and there was no change in

her actual objectives or her financial situation that would have justified the excessive level of trading or the continued trading of uncovered calls, puts, or long calls.[34]

The Hearing Panel finds that Murphy engaged in qualitatively unsuitable trading in A.L.'s account, in violation of NASD Conduct Rules 2310, 2860, 2110, and IM-2310-2.

2. Excessive and Unsuitable Trading in B.M.'s Account

The Complaint alleges that the trading in B.M.'s account was also unsuitable. In particular, the Complaint alleges that the trading was excessive in size and frequency, as shown by the cost-to-equity and turnover ratios.[35]

The turnover ratio is a commonly used measure of excessive trading in equities.[36] For the three months that Murphy managed B.M.'s account, the annualized turnover ratio was 22.62. The annualized cost-to-equity ratio was 169%. CX-35.

Although the turnover ratio and the cost-to-equity ratio were both high on an annualized basis, the Hearing Panel also considered whether it was appropriate to rely on these measures given the short time period they covered.[37] The Hearing Panel looked at the trades that Murphy made during this three-month period, and finds that the number of trades was excessive. The trading included in-and-out trading of one stock (Copper Peru). During this brief period, Murphy bought and sold nine different stocks. JX-158; JX-159; JX-160. B.M. was charged

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[34] The Commission has previously rejected a similar, but less deceptive, attempt to cover the inadvertent sale of uncovered calls by having a customer sign a new options agreement. *Clyde J. Bruff*, Exchange Act Rel. No. 31141, 1992 SEC LEXIS 2197, at *5, *11 – *12 (Sept. 3, 1992).

[35] The Complaint charges unsuitability based solely on the size and frequency of the trading in B.M.'s account. Enforcement argues that the trading was also qualitatively unsuitable because Murphy concentrated B.M.'s account, twice investing almost the entire account in a single stock. Because qualitative unsuitability is not charged in the Complaint, the Hearing Panel does not determine whether it constitutes an independent basis for a finding of a violation.

[36] *Medeck* at *35 - 36, n.18. The turnover ratio is calculated by "dividing the aggregate amount of purchases in an account by the average monthly investment. The average monthly investment is the cumulative total of the net investment in the account at the end of each month, exclusive of loans, divided by the number of months under consideration." *Pinchas*, at 339-40, n.14.

[37] *Medeck* at *47 – *48.

$5,395.77 in commissions, more than 40% of the account's average equity of $12,788.35, and 17% of B.M.'s salary. Tr. 61; CX-35.

Murphy clearly exercised *de facto* control during this period. The trades were done without authorization from the client, and, in fact, contrary to the client's instructions. B.M. was out of the country, serving in the military, receiving his statements and confirmations a month or more after they were mailed, and learned of the trading well after the fact.

Murphy violated NASD Conduct Rules 2310, 2110, and IM-2310-2 by engaging in excessive and unsuitable trading in B.M.'s account.

C. Third Cause of Action: Murphy Violated Section 10(b) of the Securities Exchange Act of 1934, SEC Rule 10b-5, NASD Conduct Rules 2120, 2310, 2110, and IM-2310-2, by Churning Customers' Accounts

"Churning occurs when a securities broker buys and sells securities for a customer's account, without regard to the customer's investment interests, for the purpose of generating commissions."[38] Churning violates Section 10(b) of the Exchange Act, Rule 10b-5, and NASD Conduct Rules 2120 and 2110.[39] Churning has been found where: (1) the broker exercised control over the account; (2) trading in an account was excessive in light of the investment objectives; and (3) the broker acted with the intent to defraud or with reckless disregard for the interests of the client.[40] Circumstantial evidence may be used to prove scienter. Reckless disregard may be inferred from the amount of commissions charged by the broker.[41] Excessive trading activity and high costs inconsistent with a customer's investment objectives and financial situation can be used to prove scienter.[42]

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[38] *Sandra K. Simpson*, 2002 SEC LEXIS 1278, at *52 (2002) (citations omitted).

[39] *Kelly* at *11.

[40] *Kelly* at *11, *18 – *19.

[41] *Kelly* at *18 – *19.

[42] *Medeck* at *53.

Murphy churned A.L.'s account. As discussed above, Murphy exercised control over A.L.'s account, and the trading in the account was excessive. The Hearing Panel also finds that Murphy acted with the intent to defraud, as well as reckless disregard for A.L.'s interests. Murphy's activity and commissions in A.L.'s account were so unreasonable in light of A.L.'s objectives that Murphy's objective must have been the continued generation of high commissions.[43] He traded very frequently over a long period of time. The commissions were so high that it would have required an extraordinary level of success merely to break even, which must have been obvious to Murphy from the outset, and even more so as the losses continued to mount. Murphy misrepresented the activity in the account by reassuring A.L. that her account was profitable and that he was continuing to follow a covered call strategy.

The extraordinary amount of trading on margin exacerbated A.L.'s risk, but also served to cover up the failure of Murphy's strategy, as it enabled him to continue to send cash to A.L., apparently satisfying her account objective of generating income. In fact, it covered up losses that reached nearly $1 million.

Murphy's continuing generation of high commissions was important to his own financial well-being. From the third quarter of 2002 through the end of 2005, 59% of Murphy's commissions came from options trades in A.L.'s account. CX-16. For an account that generated more than half of his income, and in which he traded on most trading days over a period of more than three years, his objective could only have been to generate commission income for himself, and not to generate growth and income for A.L.

Murphy also churned B.M.'s account. As noted above, Murphy exercised complete *de facto* control over B.M.'s account, and the trading was excessive. Although the trading took

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[43] *See Medeck* at *53.

place for a short period of time and the dollar amounts were much smaller than in A.L.'s account, the number of trades and the high commissions charged did not make sense for B.M. In addition, Murphy disregarded B.M.'s express instructions not to trade in the account, further suggesting that he was pursuing his own interests, and not his client's. The Hearing Panel finds that Murphy acted with extreme recklessness in trading in B.M.'s account.

The Hearing Panel finds that Murphy violated Section 10(b) of the Securities Exchange Act of 1934, SEC Rule 10b-5, NASD Conduct Rules 2120, 2310, 2110, and IM-2310-2, by churning both A.L.'s and B.M.'s accounts.

D. Fourth Cause of Action: Murphy Violated NASD Conduct Rule 2110 by Trading Beyond the Approved Level in A.L.'s Account

In the Fourth Cause of Action, the Complaint alleges that Murphy violated NASD Conduct Rule 2110 by effecting uncovered options trades during the period from August 2002 through November 2004.[44] The Complaint alleges that such trades were beyond the levels authorized by A.L. and approved by [redacted]

While Enforcement calls the violation "trading beyond approved levels," the gravamen of the charge is unauthorized trading.[45] Unauthorized trading is a "'serious breach of the duty to observe high standards of commercial honor and just and equitable principles of trade,'" and violates Rule 2110.[46]

Murphy wrote uncovered calls in A.L.'s account, a strategy that A.L. did not authorize. The uncovered calls were the result of writing calls that were beyond the level of trading of calls that was authorized. The account was not approved by [redacted] for uncovered call

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[44] The Complaint also charged that the unauthorized trading violated NASD Conduct Rule 2860, but Enforcement dropped that charge. See Post-Hearing Brief at page 15, n.108.

[45] *See, e.g., Dep't of Enforcement v. Elkins*, 2006 NASD Discip. LEXIS 26 (O.H.O. July 21, 2006).

[46] *Wanda P. Sears*, Exchange Act Rel. No. 58075, 2008 SEC LEXIS 1521, at *6 (July 1, 2008) (citation omitted); *Dep't of Enforcement v. Wiard*, No. C8A030078, 2005 NASD Discip. LEXIS 45, at *8 (N.A.C. Oct. 18, 2005).

writing until November 1, 2004, when A.L. signed the new Options Agreement and Approval Form. Murphy violated NASD Conduct Rule 2110 by selling uncovered calls without authorization from the customer or the Firm.

E. Fifth Cause of Action: Murphy Violated NASD Conduct Rules 2210, 2220, and 2110 by Causing the Creation and Distribution of Inaccurate, Unbalanced, and Misleading Communications

In the Fifth Cause of Action, the Complaint alleges that Murphy created and distributed to A.L. inaccurate, misleading, and unbalanced written communications, including several reports and sales literature. In particular, Enforcement alleges that there were certain specific deficiencies in "Profit and Loss" reports that were sent to A.L.; "Margin Account" reports; "Safe Options Strategies that can be employed;"and "A Brief look at the account of [A.L.] ... at

NASD Conduct Rule 2220(d) sets forth the requirements for communications concerning options. At the time of the violations alleged in the Complaint, Rule 2220(d)(1)(A) prohibited the use of "any advertisement, educational material, sales literature or other communications to any customer or member of the public concerning options which ... contains any untrue statement or omission of material fact or is otherwise false and misleading."[47] Rule 2220(d)(2) specifically required that the special risks attendant to options transactions be reflected in any advertisement, educational material, or sales literature that discusses the uses or advantages of options.

1. Profit and Loss Statements and Margin Reports

The Complaint alleges that Profit and Loss statements that Murphy occasionally sent to A.L. were inaccurate, unbalanced, and misleading because they overstated profits and often

[47] Rule 2220(d)(1)(B) set forth a similar standard with respect to communications with the public generally. The Rule was subsequently modified, and has been superseded by FINRA Rule 2220. See Reg. Notices 08-73, 09-60.

showed a gain when the account had suffered a loss, and that the accounting method used to calculate the profits was not identified and not used consistently. The Complaint also alleges that the account values listed on the Margin Account report sometimes included the margin debit or cash credit balance, but sometimes did not.

The parties stipulated that Murphy caused profit and loss reports to be created and distributed to A.L. Stip. 29. FINRA's investigator found numerous errors when she compared the monthly account statements to the data in 16 profit and loss reports Murphy sent to A.L. For example, the reports sometimes included incorrect dollar amounts, omitted trades, reversed purchases and sales, had incorrect dates, included margin interest credit in the profit and loss, and had mathematical errors. Tr. 490 – 511; CX-17 – 32. One report was seriously misleading because it showed a gain of $50,912.75 from April to June 2005, when there was actually a loss of $40,489.85. Tr. 500-501. In addition to the erroneous profit and loss reports, Respondent Murphy sent a similarly inaccurate report of the balance in A.L.'s margin account to A.L., also containing numerous errors. Tr. 509 – 511; JX-78; CX-33.

Murphy violated NASD Conduct Rules 2210, 2220, and 2110 by causing the misleading reports to be created, and sending the reports to A.L.

2. Document Entitled "Safe Options Strategies"

At a meeting, Murphy handed a document to A.L. that had an attachment entitled, "Safe Options Strategies that can be employed." JX-198 p. 2; JX-89; Tr. 1063 – 1064. The document erroneously stated that "[a] collar option is created when we buy a call option and sell a put option." The definition of a collar in the document was incorrect. As Investigator Julie Murphy

testified, "A collar option is created when we sell a call and buy a put on our underlying security." Tr. 518 – 519.[48]

The document was also misleading because it described a "short straddle" as a "safe strategy." As the document explains, "In a short straddle the option writer sells a call and a put on the same underlying security at the same strike price in each case." The document goes on to represent that the strategy is employed "when the underlying security trades in a narrow range and hence the buyer of the option is unable to exercise. This leaves the option writer with profit thanks to the premium he charged on both the short call and short put." This is misleading because it implies that a profit is a virtual certainty, especially because the theme of the entire document is to educate A.L. about "safe option strategies." In fact, a short straddle is not a safe strategy, but exposes the writer to substantial risk. If the price of the underlying stock declines, the writer can incur substantial losses. Tr. 519.[49]

Enforcement argues that the "Safe Options" document violates Rule 2220(d)(2) because the document does not contain certain disclosures or meet the standards for a balanced statement of the risks that the rule requires for sales literature. However, because there is no evidence that the document was sent to anyone other than A.L., the document was not sales literature, and is not covered by the affirmative disclosure requirements.

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[48] "An equity collar consists of the simultaneous purchase of a put option, and the writing of a call option. Both options are out-of-the-money, and usually have the same expiration date. Most often a collar is established against an existing equity position, with one put purchased and one call written for every 100 shares held. It is also possible to establish a collar at the same time that an equity position is purchased." "Strategies, Equity Options," available on the CBOE website at http://www.cboe.com/Strategies/EquityOptions/EquityCollars/Part1.aspx.

[49] See also discussion of short straddles at CBOE website, at http://www.cboe.com/Strategies/WeeklyStrategy.aspx?DIR=LCWeeklyStrat&FILE=112309%20-%20Short%20Straddle.doc&CreateDate=24.11.2009, describing the risk of short straddles as unlimited.

The definition of "sales literature" in the rule included "any written communication ... distributed or made generally available to customers or the public ...."[50] A document sent to a single customer is not "distributed or made generally available." Furthermore, the contrast between the coverage of Rule 2220(d)(1) and Rule 2220(d)(2) shows that the latter did not apply to correspondence with one customer. Rule 2220(d)(1) applied to "any advertisement, educational material, sales literature or other communications to any customer or member of the public," and thus clearly applied to correspondence with an individual. Rule 2220(d)(2) did not refer to "other communications to any customer," which implies that the scope of covered communications is narrower.

The history of Rule 2210 also suggests that a letter to a single customer is not sales literature. In 1998, FINRA addressed the scope of the term "sales literature" with respect to Rule 2210, and amended the rule to make it applicable to correspondence.[51] FINRA noted that NASD Regulation took the position that "sales literature" did not apply to a document prepared for a single customer, and amended the rule to "subject correspondence to the general standards and those specific standards of Rule 2210 that prohibit misleading statements, but not to the standards of the rule that prescribe specific disclosure...."[52] The same structure applies to Rule 2220(d); the general standards apply to correspondence, but the specific standards apply only to advertisements, educational material, and sales literature.

Murphy violated NASD Conduct Rules 2210, 2220, and 2110 by creating and distributing the Safe Options Strategy document to A.L. because the document included

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[50] Rule 2220(a)(3). The definition was changed by subsequent amendment. See Reg. Notice 08-73. Its successor, FINRA Rule 2220(a)(1)(C), specifically references the definition in FINRA Rule 2210.

[51] NTM 98-83.

[52] *Id.* at 637.

inaccurate and misleading statements. He did not violate Rule 2220(d)(2) in failing to make affirmative disclosures because the document is not covered by Rule 2220(d)(2).

3. Document Entitled "A Brief look at the account of [A.L.] ..."

The Complaint alleges that JX-88, a document entitled "A Brief look at the account of [A.L.] [account number] at [redacted] is inaccurate, misleading, and otherwise unbalanced because it assumes the price of P&G will increase to a certain price over the next two-month period but provides no basis for the price prediction.

There is no evidence that A.L. ever received the document. She did not recall having received it. Tr. 159. It was not included among the documents she produced to Enforcement during FINRA's investigation. Tr. 563 – 565. Her accountant may have been the only one who received it. He received it with a fax cover sheet asking him to comment, criticize, or add to the document, suggesting that it was intended only as a draft for comment. RX-63; Tr. 810.

Enforcement has not established that Murphy violated FINRA's rules with respect to this document.[53]

F. Sixth Cause of Action: Enforcement Did Not Prove that [redacted] Violated NASD Rules 3010, 2860(b), and 2110 by Maintaining Deficient Written Supervisory Procedures

The Sixth Cause of Action charges that the Firm's written supervisory procedures ("WSPs") violated Rule 3010, which required firms to establish, maintain, and enforce written supervisory procedures "reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of [FINRA]." Enforcement contends that the WSPs "failed to address adequately the manner of supervision of customer accounts maintaining

[53] The parties stipulated that Murphy caused written communications, including profit and loss reports and sales literature, to be created and distributed to A.L. Stip. 29. The stipulation does not identify which documents are intended to be considered "sales literature." Given the evidence suggesting that the document was not sent to A.L., the Hearing Panel does not interpret the stipulation so broadly as to include JX-88.

uncovered short options positions."[54] The WSPs included a variety of options procedures. For example, the WSPs required a manager's approval on the order ticket before order entry, and permitted options orders only for the type of option and dollar amount in the Options Agreement and Approval Form. Uncovered trades were required to comply with the clearing firm's margin requirements. Options trades had to be approved by Birkelbach. Compliance was required to deliver a "Special Statement" to customers before accounts could be approved for uncovered writing.[55] The WSPs also assigned Birkelbach the responsibility to review options accounts for such things as compatibility with investment objectives, size and frequency of transactions, commissions, and profit or loss. JX-12 at 29, 65, 68, 71 – 72; JX-13 at 10. Enforcement has not specified what is missing from the procedures, or why any missing procedures would have been important. The Hearing Panel declines to speculate on these issues. Enforcement has failed to establish that the WSPs were deficient because they "failed to address adequately the manner of supervision of customer accounts maintaining uncovered short options positions."

Enforcement also contends that the procedures did not contain an adequate process for the review of options trades for suitability. As shown above, there were procedures for the review of every options trade by Birkelbach, including a review for issues related to suitability. While the system clearly failed in the case of A.L.'s account, Enforcement has not shown that the failure is the result of inadequate written supervisory procedures, as opposed to Birkelbach's failure to apply the procedures diligently.

Enforcement further contends that the WSPs were deficient because they failed to describe the steps to be taken if suspicious activity was detected in an account that traded options. Enforcement cited no authority that supports the existence of such a requirement. It

[54] Department of Enforcement's Post-Hearing Memorandum at 23.

[55] NASD Rule 2860(b)(11) required firms to distribute a "Special Statement" to short options writers.

would be difficult to fashion such procedures, given the variety of situations that can arise. The appropriate response to the detection of suspicious activity would vary, depending on many factors, such as the nature of the activity, any explanation that might be offered by those involved, and the supervising principal's knowledge of the parties involved in the activity, for example. Furthermore, any suspicious activity in *options* should have certainly come to Birkelbach's attention, and he could have taken whatever action was necessary and appropriate. Enforcement has failed to establish that the failure of the WSPs to spell out such a procedure was unreasonable

Enforcement also has not established that the failure to have a provision for heightened supervision in the Firm's WSPs violates Rule 3010. There is no provision in Rule 3010 that requires a firm's written supervisory procedures to have procedures for heightened supervision, FINRA considered such a provision in 2003, but the Rule amendment was never adopted.[56]

The NAC's decision in *J. Alexander Securities, Inc.*[57] did not establish a general requirement for inclusion of procedures for heightened supervision in a firm's WSPs. In that case, the NAC found that the respondent firm had violated FINRA's Rules by its inadequate supervision of a representative with a history of serious disciplinary problems. In finding that the firm had failed to provide for heightened supervision of the representative, the NAC held, "We therefore find that ... Alexander Securities ... failed to supervise adequately the activities of Rosen by not establishing written procedures to provide for heightened supervision of associated

[56] NTM 03-49. The proposed Rule amendment required the establishment of such procedures only if the firm was aware that an associated person had a history of apparent disciplinary problems, under specific criteria set forth in the proposed amendment.

[57] *Dep't of Enforcement v. J. Alexander Sec., Inc.*, No. CAF010021, 2004 NASD Discip. LEXIS 16 (N.A.C. Aug. 16, 2004), *aff'd sub nom. Robert J. Prager*, Exchange Act Rel. No. 51974, 2005 SEC LEXIS 1558 (July 6, 2005). Enforcement did not cite this case in support of its contention that the failure to have such procedures violates FINRA's Rules.

persons with disciplinary histories, in violation of NASD Conduct Rules 2110 and 3010."[58] The decision did not establish a blanket requirement that written supervisory procedures have provisions for heightened supervision. Rather, consistent with NTM 03-49, the case established that, under the circumstances of that case, the firm's failure to have such procedures was a failure to supervise.

Enforcement failed to establish that the Firm's written supervisory procedures were not reasonably designed to achieve compliance with applicable securities laws and regulations, and FINRA's Rules.

G. Seventh Cause of Action: Birkelbach Violated NASD Conduct Rules 3010, 2860(b)(20), and 2110 by Failing to Supervise Murphy

The Seventh Cause of Action charges Birkelbach with inadequate supervision of Murphy's handling of A.L.'s and B.M.'s accounts.

Conduct Rule 3010(a) provides that "[e]ach member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules."[59] NASD Conduct Rule 2860(b)(20) specifically requires supervision of options trading. When there are indications of possible irregularities, or "red flags," in an account, a supervisor must investigate the red flags and respond appropriately.[60] Furthermore, "[W]here a supervisor discovers red flags indicating

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[58] *Id.* at *54.

[59] Failing to supervise also violates Conduct Rule 2110. *Dep't of Enforcement v. VMR Capital Markets*, No. C02020055, 2004 NASD Discip. LEXIS 18, at *15 (N.A.C. Dec. 2, 2004).

[60] *Ronald Pellegrino*, Exchange Act Rel. No. 59125, 2008 SEC LEXIS 2843, at *33 (Dec. 19, 2008).

trading irregularities, the supervisor cannot 'discharge his or her supervisory obligations simply by relying on the unverified representations of employees.'"[61]

1. Birkelbach Failed to Supervise Murphy's Handling of A.L.'s Account

From the third quarter of 2002 through the end of 2005, commissions from A.L.'s account were a substantial part of both Murphy's and the Firm's revenues. During this period, 59% of Murphy's commissions came from options trades in A.L.'s account. A.L. was the Firm's largest client. Eighteen percent of the Firm's revenues came from Murphy's options trading in A.L.'s account. Murphy generated 30% of total Firm revenues during this period. CX-16; Tr. 1131.[62]

Birkelbach was the Firm's SROP and CROP from October 2001 through February 2006. Stip. 3. All options trades required his approval. Tr. 1116. Birkelbach approved the level of options trading in A.L.'s account. Tr. 758. He reviewed the options trades for the Firm daily. Tr. 783, 1116 – 1117. From his review of the trading, Birkelbach knew that Murphy effected uncovered option transactions from August 2002 through October 2004 in A.L.'s account. Stip. 31. Birkelbach believed that Murphy talked to A.L. before he effected option trades in her account. Stip. 30. Birkelbach spoke to Murphy about A.L.'s trades. They discussed the reasons for the trades. Tr. 1104.

George Langlois was the Firm's compliance officer for most of the period covered by the Complaint, but he was not a registered options principal. He was not very knowledgeable about options. Stip. 4, 5; Tr. 758. Langlois reviewed trades at the end of each day. Tr. 764 – 765, 783. Langlois often had concerns about whether all trades were authorized and suitable, so he

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[61] *VMR Capital Markets*, at *33 – *34 (N.A.C. Dec. 2, 2004) (citing *Michael H. Hume*, 52 S.E.C. 243, 248 (1995) (involving excessive trading)).

[62] The percentages are undoubtedly even higher for the peak years of 2004 and 2005, but those percentages calculations are not in the record.

discussed A.L.'s account with Murphy frequently. Tr. 749, 789. Murphy told Langlois that all trades were authorized by A.L. Tr. 767 – 769, 792 – 793. Langlois's concerns about Murphy's handling of A.L.'s account were generally resolved to Langlois's satisfaction, but if they were not resolved, he brought the matters to Birkelbach's attention. Tr. 750. When A.L.'s account was running large losses, Langlois brought them to Birkelbach's attention. Tr. 771 – 772. Birkelbach spoke to Langlois about A.L.'s account almost every day. Tr. 1101.

From September 5, 2002, until April 1, 2005, Langlois sent eight letters to A.L., confirming that the activity in her account was consistent with her investment objectives and financial situation. Langlois conferred with Birkelbach before sending activity letters. He sent them whenever he had any concern over activity in an account. The letters noted the high level of options activity in A.L.'s account, and asked A.L. to sign and return the letters to confirm that she understood their contents. JX-80 – 87; RX-40; Tr. 750 – 751. The letter of November 11, 2003, also noted that $251,781 in commissions had been charged to the account. JX-84. Murphy assured A.L. that the letters were routine, and that she should sign them and send them back. Tr. 143, 146 – 147. When A.L. received the letter of November 11, 2003, she called Murphy, who told her not to worry about the large commissions, and that she was making a profit. Tr. 147 – 148. A.L. relied on verbal assurances from Murphy that the account was profitable. Tr. 318.

There were numerous red flags that should have caused Birkelbach to investigate Murphy's handling of A.L.'s account. The dramatic change in the account activity soon after Murphy took over the account should have caused Birkelbach to be concerned that Murphy might be handling the account improperly, and not in accordance with the client's objectives.[63]

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[63] *See Paul C. Kettler*, Exchange Rel. No. 31354, 1992 SEC LEXIS 2750, at *7 (Oct. 26, 1992).

Birkelbach knew that A.L. did not want to lose her P&G stock,[64] yet it was inevitable, as the losses mounted and the stock was pledged to cover her large and increasing margin balance, that P&G stock would ultimately have to be sold. The large volume of activity, the high commissions, the concerns regularly expressed by Langlois, the in-and-out trading, the extensive use of margin, and the trades of highly speculative options, such as uncovered calls and puts that were neither approved nor suitable for A.L., should have put Birkelbach on notice of actual and potential problems.[65] Birkelbach never disapproved any of Murphy's options trades. Tr. 1117.

The notification by a FINRA examiner that the Firm had written uncovered calls in A.L.'s account without proper authorization also should have been an important red flag. It should have alerted Birkelbach that the Firm's procedures and his own review of Murphy's trading were failing to identify Murphy's unauthorized trading in speculative options, and that Murphy could not be relied upon to handle this account properly.

Birkelbach and the Firm did very little to verify independently that Murphy's trading in A.L.'s account was proper. Birkelbach made no independent effort to verify that the trades were approved by A.L. before they were made, instead relying on his observation that when he visited Murphy's office he frequently seemed to be speaking to A.L. on the telephone. JX-202 at 120 – 121. The activity letters that Langlois sent to A.L. were insufficient to verify that there were no problems in A.L.'s account. They did not inform A.L. of the most important facts – that Murphy had far exceeded his authority by engaging in risky uncovered options trading, and that A.L. was losing a substantial amount of money on Murphy's trading. Rather than require Murphy to follow the client's preferred strategy of writing covered calls, Birkelbach approved and

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[64] Tr. 1100.

[65] *VMR Capital Markets*, at *28 – *29 ; *Albert Vincent O'Neal*, Exchange Act Rel. No. 34116, 1994 SEC LEXIS 1639, at *15 – *16 (May 26, 1994).

participated in a deceptive strategy of having A.L. sign her original Options Agreement and Approval Form for a second time on November 1, 2004, with additional check marks added purporting to authorize more speculative trading in uncovered options. Murphy continued the unsuitable and excessive trading for another year, until A.L. realized what was happening and moved her account.

The numerous red flags called for direct contact between Birkelbach and A.L.[66] Although Birkelbach and Murphy eventually met with A.L., her accountant, and her financial advisor for lunch in May 2005, the lunch was mostly social. Tr. 810 – 813. But even if there had been a full and frank discussion of the losses and the nature of the activity in A.L.'s account, the discussion would have been much too late.

Murphy's improper handling of A.L.'s account was readily apparent from the basic data, and clearly unsuitable for A.L., yet Birkelbach allowed the improper trading to go on for many months after he should have intervened. Birkelbach did not adequately supervise Murphy's handling of A.L.'s account, thereby violating NASD Conduct Rules 3010, 2860(b)(20), and 2110.

2. Birkelbach Failed to Supervise Murphy's Handling of B.M.'s Account

Birkelbach was responsible for supervising Murphy's trading in B.M.'s account. Stip. 43. By the time Birkelbach transferred B.M.'s account to Murphy in April 2007, there were red flags about Murphy. Birkelbach knew that FINRA had been investigating Murphy's activities in A.L.'s account since at least January 11, 2006. JX-167. There had been substantial correspondence, production of documents, and a Wells submission. Murphy and Birkelbach both testified in FINRA on-the-record interviews during the time that Murphy was handling

[66] *Albert Vincent O'Neal*, at *15 – *16.

B.M.'s account. JX-167 – JX-176; JX-202. In April 2, 2007, Respondents and A.L. settled an arbitration claim filed by A.L. against the Respondents. Stip. 35; JX-146. In addition, Birkelbach was aware of the fact that, in 1998, the Chicago Board Options Exchange, Inc. ("CBOE") had found that Murphy made discretionary trades in options and securities without advance written approval from his clients and his prior broker-dealer. Stip. 7; Tr. 993 – 994; JX-3. This regulatory and litigation history should have alerted Birkelbach to the need for heightened supervision of Murphy.[67]

Birkelbach had spoken to B.M. soon after the account was transferred to Murphy (Tr. 101), and must have known that B.M. was stationed overseas. Birkelbach reviewed the trading activity in B.M.'s account each day (Tr. 1127 – 1128), so he was aware of the frequency of the trades and the large commissions that B.M. was paying relative to the size of the account. These factors, along with the issues that had arisen with respect to Murphy's handling of A.L.'s account, should have prompted Birkelbach to monitor Murphy's handling of B.M.'s account. He clearly did not, and the result was unauthorized discretionary trading, excessive trading, and churning.

Birkelbach failed to supervise Murphy in his handling of B.M.'s account, thereby violating NASD Conduct Rules 3010, 2860, and 2110.

3. Misleading Correspondence

Birkelbach reviewed the P&L statements and letters that Murphy sent to A.L. Stip. 33. Although he looked at them, he did not check the calculations, and did not know if anybody at the Firm had looked at them carefully. Tr. 1121 – 1122. At a minimum, Birkelbach should have

[67] *Robert J. Prager*, Exchange Act Rel. No. 51974, 2005 SEC LEXIS 1558, at *42 (July 6, 2005); NTM 97-19, at 158 – 160.

ensured that the Firm spot-checked the calculations. Given the number of errors, clearly nobody did.

In addition, Birkelbach failed to identify the errors in the document entitled, "Safe Options Strategies that can be employed." JX-198; JX-89. Those errors included basic errors in Murphy's description of how options strategies worked. As the Firm's SROP and CROP, as well as its president, Birkelbach should have caught those errors. A more careful review would have prevented misleading documents from being sent, and would have highlighted Murphy's lack of options expertise. Birkelbach violated NASD Conduct Rules 3010, 2860 and 2110 by failing to review the correspondence with care.

H. Eighth Cause of Action: [redacted] Did Not Violate NASD Conduct Rules 3110 and 2110 and SEC Rule 17a-4 by Failing to Maintain Correspondence in Files

The Eighth Cause of Action charges the Firm with failure to maintain correspondence in the Firm's files, in violation of NASD Conduct Rules 3110 and 2110, and SEC Rule 17a-4. The basis for the charge is that A.L. had two pieces of correspondence that Enforcement contended the Firm should have had in its files, and one letter suggested that there had been an earlier letter that was not in the files.

When the FINRA investigator asked the Firm to produce all correspondence with A.L., it did not produce two of the profit and loss statements that FINRA had obtained from A.L. It instead produced different versions of the documents. The profit and loss statement that A.L. produced for the period January 1, 2002, to December 31, 2002, had a different format than the one the Firm provided. The Firm produced a profit and loss report for January 1, 2003, to February 18, 2003, that showed a different realized profit than the document A.L. provided to FINRA for the same period. In addition, an activity letter dated September 5, 2002, that both

A.L. and the Firm produced indicated that it was a second request, but the Firm did not provide the first request. Tr. 520, 523 – 525; JX-70; JX-71; JX-80.

The Hearing Panel finds that Enforcement has not proven that there was a violation. With respect to the profit and loss statements, the slipshod way in which they were prepared initially may account for the differences between the versions the firm had and the version that A.L. produced. There is too little evidence of how the documents were prepared and sent to A.L. to find that the failure to produce the documents reflected a failure to maintain records, especially in light of Murphy's overall manner of handling A.L.'s account. The label "second request" on the activity letter is an insufficient basis to prove that there had been a first request. Neither the Firm nor A.L. had a copy of such a document, supporting the likelihood that it never existed. While A.L. was not careful about reviewing correspondence from the Firm, she produced a substantial quantity of correspondence, and was diligent about keeping it. Furthermore, the activity letters were form letters that were modified for use with individual clients (Tr. 752), and the "second request" label on the document could have been an artifact from a letter to another client. Given the circumstances and nature of the documents, the Hearing Panel does not believe that it is appropriate to find that the failure to have these documents in the Firm's files constitutes a violation.

I. Ninth Cause of Action: [redacted] Violated NASD Conduct Rule 2110 by Using an Improper Confidentiality Provision in a Settlement Agreement with a Customer

FINRA member firms are prohibited from using confidentiality provisions in settlement agreements that would impede or discourage other persons from cooperating with FINRA. FINRA has reminded its members on a number of occasions that such confidentiality provisions are prohibited.

In 1995, FINRA members were reminded that settlement agreements that prohibit or discourage customers or other persons from disclosing the terms of the settlement, and the underlying facts of the dispute, to FINRA or other securities regulators, violated the NASD Rules of Fair Practice.[68] FINRA members were again reminded of the prohibition against restrictive confidentiality provisions in settlement agreements in a Notice to Members in 2004. FINRA noted that "some member firms continue to use confidentiality provisions that prohibit or restrict the customer or other person from disclosing the settlement terms and the underlying facts of the dispute upon inquiry to NASD or other securities regulators, despite repeated NASD communications cautioning members against this practice." The 2004 NTM specifically advised members that it is impermissible to include confidentiality provisions that require regulatory authorities to obtain a court order or subpoena before the parties are permitted to disclose the terms of a settlement or the underlying facts of the dispute, noting, "[S]uch restrictive language is especially problematic for self-regulatory organizations (SROs), such as NASD, that do not have the legal authority to compel cooperation by customers or other persons not subject to the SROs' jurisdiction."[69]

FINRA has advised its members that the confidentiality provisions of settlement agreements must "expressly authorize the customer or other person to respond, without restriction or condition, to any inquiry about the settlement or its underlying facts and circumstances by any securities regulator, including the NASD."[70] The NAC has held that the inclusion of an improper confidentiality provision that fails to include express language

[68] NTM 95-87, 1995 NASD LEXIS 124 (October 1995).

[69] NTM 04-44, 2004 NASD LEXIS 49 (June 2, 2004).

[70] NTM 95-87.

authorizing a customer to respond to a FINRA inquiry about the settlement or its underlying facts is a violation of NASD Conduct Rule 2110.[71]

A.L. filed an arbitration against Respondents, alleging that they had handled her account improperly by churning the account and making misrepresentations. On April 2, 2007, Respondents and A.L. settled the dispute for $150,000. The agreement settling the arbitration between A.L. and Respondents included the following provision:

> In this connection, however, [A.L.] acknowledges that there is currently an investigation of the [Respondents], by NASD-Regulation, Inc., and should this investigation evolve into a formal administrative disciplinary proceeding against any one or more of the [Respondents], [A.L.] will only provide testimony or documents under subpoena or other lawful process.

Stip. 35; JX-146. The majority of the Hearing Panel finds that the inclusion of this provision violated NASD Conduct Rule 2110.[72]

VI. Sanctions

A. Sanction Against Murphy

Murphy's violations for exercising discretion without written authority, unauthorized trading, unsuitable and excessive trading, and churning are all part of the same course of conduct, and it is appropriate to consider them collectively in imposing sanctions. Because the appropriate sanction for those violations is a bar, the Hearing Panel does not impose a separate sanction for creating and distributing of misleading communications.

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[71] *Dep't of Enforcement v. America First Associates Corp.*, 2008 FINRA Discip. LEXIS 27, at *25 (N.A.C. Aug. 15, 2008).

[72] One member of the Hearing Panel dissents from this finding, for the reasons set forth in the attached Hearing Panelist's Dissenting Statement with Respect to the Ninth Cause of Action.

1. Sanction Guidelines for Exercise of Discretion Without Written Authority, Unauthorized Trading, Unsuitable and Excessive Trading, and Churning

The Sanction Guidelines recommend a sanction of up to a bar in egregious cases for unauthorized trading, unsuitable recommendations and excessive trading, and churning. For discretionary trading, the Sanction Guidelines recommend a fine and a suspension of 10 to 30 business days. The respective guidelines also recommend fines.[73]

The principal considerations for unsuitable recommendations, excessive trading, and churning are those in the introductory section to the Guidelines.[74] For unauthorized trading, the principal considerations are whether the respondent misunderstood his or her authority or the terms of the customer's orders, and whether the unauthorized trading was egregious.[75] For exercising discretion without written authority, the principal considerations are "[w]hether customer's grant of discretion was express or implied," and "[w]hether firm's policies and/or procedures prohibited discretionary trading and/or whether the firm prohibited the respondent from exercising discretion in customer accounts."[76]

2. Murphy's Violations with Respect to A.L.'s Account Were Egregious

Respondent's violations in handling of A.L.'s account were egregious. Soon after the account was assigned to him, he began to write uncovered calls, a strategy that was not authorized, and exposed A.L. to enormous risk. He also began to write puts, another strategy that was not authorized, and exposed A.L. to significant risk. His purchase of calls was contrary to A.L.'s desire to generate cash income, and a risky strategy. All were inconsistent with A.L.'s investment objectives, and were unsuitable.

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[73] Sanction Guidelines at 82, 90, 99, 103.

[74] Sanction Guidelines at 82, 99.

[75] Sanction Guidelines at 103.

[76] Sanction Guidelines at 90.

The misconduct extended over a period of three and a half years. Murphy traded more than 67,000 P&G options contracts during that period. At the end of every month from August 2002 through August 2004, there were uncovered positions in A.L.'s account. From July 2002 until November 2004, the account was "short" at least one position, either short puts, uncovered calls, or short combinations, on 277 trading dates. Tr. 487.[77]

Murphy could not have believed that his trades were authorized by the client. He knew that she intended to engage in a covered call strategy. Murphy concealed his misconduct from his client. He repeatedly assured A.L. that she was making money writing covered calls, while the losses grew as he wrote uncovered calls and puts, and purchased calls in addition to writing covered calls. He also concealed the fact that A.L. was not approving each trade from the Firm, assuring Langlois, the Firm's compliance officer, that A.L. was approving every trade.

The misconduct was extremely profitable to Murphy, but extremely costly for A.L. He earned substantial commissions from his trading in A.L.'s account, but the bulk of his commissions came from trading other than the covered call strategy that he was retained to implement. The commissions charged to A.L. were as follows:

[77] Enforcement represents in its post-hearing brief that there were uncovered positions on more than 300 trading days from July 2002 through October 2004. It does not explain why its estimate is somewhat higher than the number to which the FINRA investigator testified. The difference is not material. It is clear that there were uncovered puts or calls in A.L.'s account on a large number of trading days while Murphy was managing the account. CX-7; CX-12.

Commissions by Type of Options
July 2002 – February 2006[78]

Strategy Effected by Murphy	Commissions Paid by A.L.
Covered Call	$308,170.17
Long Call	$404,943.05
Short Put	$227,931.71
Short Call[79]	$61,055.97
Total	$1,002,100.90

Murphy's payout was 60% of gross commissions from July 2002 through December 2003, and 58% after that. Stip. 10. Thus, Murphy personally received almost $600,000 in commissions from his trading in A.L.'s account.

While Murphy and the Firm profited handsomely, Murphy's client suffered very substantial harm, losing almost $1 million from Murphy's options trading. Tr. 481, 584 – 586; CX-5 at 97; CX-15.

3. Murphy's Violations with Respect to B.M.'s Account Were Egregious

Murphy's violations with respect to B.M.'s account were also egregious. Murphy began exercising discretion in B.M.'s account immediately, although he knew he did not have written discretionary authority, and B.M. had explicitly instructed him not to make trades in his account. Furthermore, Murphy should have been especially attentive to the procedures required for exercising discretion since he knew he was being investigated by FINRA for, among other things, improperly exercising discretion in A.L.'s account. JX-172.

[78] Pursuant to the Hearing Officer's Order of October 16, 2009, Enforcement compiled this information from data in the hearing record, and submitted it in a Supplemental Filing to Its Post-Hearing Brief.

[79] Enforcement used the term "short call" consistently throughout the hearing as synonymous with "uncovered call."

Murphy earned commissions from his excessive trading in B.M.'s account. Although small in absolute terms, they were substantial compared to the size of the account.

Murphy engaged in his behavior knowing that B.M. was stationed in Germany, serving in the military. The distance made B.M. more vulnerable, and Murphy knew that B.M. would not even see his account statements or trade confirmations for a month after they were mailed.

4. Other Considerations

As referenced above, Murphy has a disciplinary history involving discretionary trades in options and securities without advance written approval from his clients and his prior broker-dealer. In 1998, the CBOE found that Murphy's conduct in making such trades was inconsistent with CBOE Rule 4.1, Just and Equitable Principles of Trade and also with respect to certain options transactions, violated CBOE Rule 9.10(a) Discretionary Accounts – (Authorization and Approval Required). The CBOE censured Murphy, barred him from association with any CBOE member organization for two months, and fined him $10,000. The United States Securities and Exchange Commission sustained the CBOE's disciplinary action against Murphy on August 27, 1999. Stip. 7; Tr. 993 – 994; JX-3.

Murphy has shown no remorse for his actions. In fact, at the hearing, he seemed almost defiant at times in defending his actions.

5. Sanctions Imposed on Murphy

The appropriate sanction for Murphy's violations is a bar in all capacities, as well as a fine requiring disgorgement of ill-gotten gains. The Sanction Guidelines provide that adjudicators should impose a fine in sales practices cases if the respondent has retained substantial ill-gotten gains.[80] Murphy's payout on the commissions received from trades in

[80] Sanction Guidelines at 10; *Dep't of Enforcement v. Meyers.*, No. C3A040023, 2007 NASD Discip. LEXIS 4, at *40 – *41 (N.A.C. Jan. 23, 2007).

A.L.'s account was $588,804.12.[81] His payout on trades in B.M.'s account was $3,129.55. His total commissions on the improper trading discussed in this decision were $591,933.67. Those commissions should be disgorged.

B. Sanctions Against Birkelbach for Failure to Supervise

For failure to supervise, the Guidelines recommend a fine of $5,000 to $50,000. In addition, the Guidelines recommend consideration of a suspension of the responsible individual in all supervisory capacities for up to 30 business days, and, in egregious cases, a suspension of up to two years or a bar. The principal considerations are whether respondent ignored "red flag" warnings that should have resulted in additional supervisory scrutiny; the nature, extent, size and character of the underlying misconduct; and the quality and degree of supervisor's implementation of the firm's supervisory procedures and controls.[82]

Birkelbach repeatedly looked past the red flags in both A.L.'s and B.M.'s accounts, allowing Murphy's misconduct to continue. The underlying misconduct itself was egregious, of substantial scope and duration, with injury to A.L. that could have been alleviated at any point over a period of more than three years if Birkelbach had intervened. While Birkelbach reviewed every trade, he clearly did not evaluate them, or he would have understood very early on that Murphy was engaging in excessive, unsuitable, and unauthorized trading.

Because the violation was egregious, the appropriate sanction is both a fine and a suspension in the relevant principal capacities. A fine of $25,000 will be appropriately

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[81] Murphy's payout was 60% of gross commissions from July 2002 through December 2003, and 58% of gross commissions from January 2004 through February 2006. Stip. 10. Gross commissions on trades in A.L.'s account were $379,281.44 from July 2002 through December 2003, with Murphy's share being $227,568.86. Gross commissions on trades in A.L.'s account from January 2004 through January 2006 were $622,819.48, with Murphy's 58% being $361,235.26. CX-1. As noted above, gross commissions on trades in B.M.'s account were $5,395.77, making Murphy's share $3,129.55. Murphy's total commissions from the improper trading in this decision were thus $591,933.67.

[82] Sanction Guidelines at 108.

remedial. In addition, Birkelbach is suspended for six months as a general securities principal and an options principal, and required to re-qualify before serving again in either of those principal capacities.[83]

C. Sanction Against [redacted] for Improper Confidentiality *Provision* in Settlement Agreement

The Sanction Guidelines for including an improper confidentiality clause in a settlement agreement recommend a fine of $2,500 to $50,000, and consideration of a suspension of the individual respondent, the firm, or both, with respect to any or all activities or functions for a period of one month to two years. The principal considerations are: (1) the nature of the restriction contained in the confidentiality clause; (2) whether the respondent voluntarily released the customer from the terms of the confidentiality agreement without regulatory intervention; and (3) whether the respondent released the customer from the terms of the confidentiality agreement (as applied to cooperation with regulatory authorities) after the regulator advised respondent to do so.[84]

The restrictive provision in the settlement agreement prohibited A.L. from testifying or providing documents in a formal proceeding unless she received a subpoena or other lawful process requiring her testimony, procedures that are unavailable in FINRA proceedings. It did not prohibit cooperation with the staff's investigation. When FINRA called Respondents' attorney's attention to the impropriety of the provision, he promptly notified A.L.'s attorney that the Settlement Agreement should not be construed to prohibit or restrict A.L. from responding to FINRA about the settlement or its underlying facts and circumstances. Stip. 36.

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[83] He is not suspended in his other principal capacities because his supervisory failures were unrelated to municipal securities or financial operations.

[84] Sanction Guidelines at 34.

The majority of the Hearing Panel finds that the appropriate sanction is a fine of $2,500. For the reasons set forth in the attached dissenting statement, one member of the Hearing Panel does not believe that the inclusion of the confidentiality provision constitutes a violation of Rule 2110 under the facts and circumstances of this case, and would not impose any sanction.

D. Restitution

A.L. settled her claims for the trading that is the subject of this proceeding with Respondents after filing an arbitration claim, and she executed a settlement agreement that included a general release of all claims against Respondents. Both sides were represented by counsel. The case was resolved through mediation. Tr. 178 – 179, 373 – 379, 381 – 382; JX-146.

B.M. complained about Murphy's handling of his account to the Illinois Department of Securities and FINRA. Tr. 83, 85. He believed he had lost about $5,000. Tr. 61. After FINRA started its investigation, Respondents settled with B.M. for $3,000. B.M. executed a settlement agreement that included a general release. Tr. 64, 88; JX-162; RX-78.

The NAC has held that restitution is inappropriate under the circumstances of this case. "Absent a finding that a customer's settlement with a member or an associated person was procured by fraud, we will not second guess whether a settlement was insufficient or unwise by ordering the payment of additional funds to a settling customer."[85] There is no evidence that either settlement was procured by fraud. Restitution is not appropriate.

VII. Conclusion

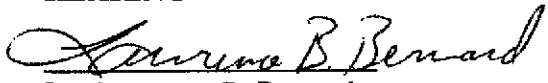
Respondent William J. Murphy is barred from associating with any member firm. Murphy is also fined $591,933.67, as disgorgement of commissions. The bar shall become

[85] *Dep't of Enforcement v. Kaweske*, No. C07040042, 2007 NASD Discip. LEXIS 5, at *54 (N.A.C. Feb. 12, 2007).

effective immediately if this decision becomes FINRA's final action. Respondent Carl M. Birkelbach is fined $25,000, suspended from acting as a general securities principal or options principal for six months, and ordered to re-qualify before serving in those principal capacities. If this decision becomes FINRA's final action in this matter, Birkelbach's suspension shall begin at the opening of business on July 6, 2010, and end at the close of business on January 5, 2011. Respondent [redacted] is fined $2,500.

In addition, Respondents shall jointly and severally pay costs in the amount of $9,503.17, which represent the cost of the hearing transcript together with a $750 administrative fee.[86] The fines and costs shall be payable on a date set by FINRA, but not less than 30 days after this decision becomes FINRA's final disciplinary action in this matter.

HEARING PANEL



By: Lawrence B. Bernard
Hearing Officer

[86] The Hearing Panel has considered and rejects without discussion all other arguments of the parties.

Hearing Panelist's Dissenting Statement with Respect to Ninth Cause of Action (Improper Confidentiality Provision in Settlement Agreement)

Under the specific facts and circumstances of this case, I do not believe the Firm violated Rule 2110 by signing the settlement agreement containing the confidentiality provision. While the confidentiality provision is improper under FINRA's Rules and notices, the firm's behavior was not unethical. The circumstances suggest that the confidentiality provision was inserted by counsel.[87] Counsel for both parties in the arbitration were experienced attorneys, and Respondents' counsel was especially experienced in FINRA matters. Additionally, the provision did not prohibit cooperation with FINRA investigators. When FINRA informed Respondents' counsel that the provision was improper, he immediately took corrective action. Stip. 36. Ultimately, A.L. cooperated extensively with FINRA investigators, and testified at the disciplinary hearing.

The NAC has repeatedly emphasized that Rule 2110 is fundamentally an ethical rule. For example, the NAC recently stated, "The scope of NASD Rule 2110 is broad – the rule's ethical and legal obligations are not limited to the sale of securities, but encompass a wide variety of unethical business-related conduct."[88] Under these circumstances, I do not believe that the inclusion of the confidentiality provision was unethical.

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[87] Although there was no specific testimony to that effect, counsel suggested during his opening statement that he, and not his client, was responsible for inclusion of the provision. Tr. 35 – 36. Respondents' counsel participated in the mediation that led to the settlement of the arbitration, and signed the settlement agreement. Tr. 383; JX-146.

[88] *Dep't of Enforcement v. Vines*, No. 2006005565401, 2009 FINRA Discip. LEXIS 16, at *9 (N.A.C. Aug. 25, 2009); *see also*, e.g., *Dep't of Enforcement v. Bukovcik*, No. C8A050055, 2007 NASD Discip. LEXIS 21, at *11 (N.A.C. July 25, 2007); *Dep't of Enforcement v. Shvarts*, No. CAF980029, 2000 NASD Discip. LEXIS 6, at *11 (N.A.C. June 2, 2000) ("Disciplinary hearings under Conduct Rule 2110 are ethical proceedings, and one may find a violation of the ethical requirements where no legally cognizable wrong occurred.") (citation omitted).

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